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SENSITIVE

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SUBJECT: GERMANY DEFENDS EXPORT MODEL BUT EXAMINES WAYS TO
BOOST CONSUMPTION

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¶1. (SBU) SUMMARY. In December 7 meetings in Berlin, German officials expressed a cautious optimism about Germany's recovery, but stressed that downside risks remain, particularly weaknesses at state-owned banks ("Landesbanken"). They were also concerned about Greece's debt position and the threat it could pose to the Eurosystem, suggesting that Greece might need an IMF program to ensure fiscal sustainability. Officials defended Germany's export-led growth model, while reluctantly acknowledging the need to increase domestic consumption and address the broader issue of imbalances in the G-20. On G-20 priorities, financial market regulatory reform and Chancellor Merkel's Charter for Sustainable Economic Activity top Germany's list. Economics Ministry officials saw a continuing consultative role for the G-8. END SUMMARY.

FINANCE MINISTRY: ROLF WENZEL

¶2. (SBU) Rolf Wenzel, Director General, Ministry of Finance, told U.S. Treasury Deputy Assistant Secretary Christopher Smart, Director for Europe and Eurasia Eric Meyer, Representative for Europe Matthew Haarsager, and International Economist Lawrence Norton, that he was concerned about the UK and Greek budget deficits. He noted that the European Central Bank (ECB) wanted financial market support measures to be withdrawn. While the Baltics were "on track," Bulgaria and Romania needed to address governance and corruption issues. Wenzel dismissed the notion that Germany's troubled state-owned banking ("Landesbank") sector would weigh on the federal government's finances, claiming they were "someone else's problem" -- namely, that of the state government and savings bank association owners.

¶3. (SBU) Wenzel was interested in reforms to financial sector compensation in the United States, saying they were "high on the political agenda." On the G-20's balanced growth framework, he stressed the need to focus more on exchange rate policy, noting that the IMF recommended an appreciation of the Chinese renminbi. He argued that German stimulus spending on construction projects and child credits were intended to increase domestic consumption, but thought there

was little else the government could do to decrease its surpluses. Wenzel bristled at the suggestion that Germany might cut the value-added tax (VAT) rate to boost consumption, arguing that the consequences would be too dire on public finances and that most Germans would just save the money anyway. He likewise rejected the suggestion that Europe shies away from confronting Ukraine because of its dependency on Russian gas that traverses the country. Wenzel said he believed the European Bank for Reconstruction and Development (EBRD) would remain flexible on shareholder participation in a temporary capital increase.

ASSOCIATION OF GERMAN BANKS: BERND BRABAENDER

¶4. (SBU) Bernd Brabaender, Managing Director, Association of Germany Banks estimated that private German banks had already written off 90 billion euros in "toxic assets," with another 70 billion euros to come. German banks would likely perform well in the 4th quarter of 2009 and 1st quarter of 2010, but do less well thereafter -- much depends on the global recovery. Of concern is the Landesbank sector, which is full of "zombie banks." Brabaender saw the Copenhagen climate talks as a potential boon for Germany, as German firms are on the "cutting edge" of green technology.

¶5. (SBU) On banking supervision, Brabaender considered the recent decision to transfer authority from the regulator Bafin to the Bundesbank irrelevant and said that the government needed to pay more attention to EU financial regulatory reform. He noted that German supervisors were under pressure not to exacerbate the "credit crunch" by being too strict. On Tier 1 capital, German private banks are in good shape, averaging 10 percent, though new rules under

discussion in the Basel Committee could force them to start building new capital soon, further restricting credit. He thought restarting securitization markets could help, although this would require some sort of government guarantee and the German public is deeply skeptical. Brabaender worried about the long-term consequences of Germany's short-shift ("Kurzarbeit") program, and how productivity might be hurt.

CHANCELLERY: ANDREAS NICOLIN

¶6. (SBU) Andreas Nicolin, economic advisor at the Chancellery, was cautious on Germany's economic outlook, adding that German banks would have further write downs. Germany and France need a common line on budget deficits within the EU to encourage consolidation in countries like Greece, he said. The IMF could more effectively deal with Greece than could the EU, where member states are reluctant to be tough. Nicolin acknowledged that proposed tax cuts -- 8.5 billion euros in 2010 and 19 billion in 2011 -- would complicate Germany's fiscal situation. The hope is, however, that stronger growth will increase tax revenues. On imbalances, Nicolin said Germany's export-led growth model was sustainable, and that the onus was on current account deficit countries within the Eurozone to "improve competitiveness."

¶7. (SBU) Nicolin said Germany reluctantly accepted the G-20's balanced growth framework. Germany's real priorities in the G-20, however, are: 1) financial market regulation; and 2) Merkel's Charter for Sustainable Economic Activity. On the former, Germany will push for the implementation of agreed action plans. On the latter, the focus will be on getting an agreed Charter document by the end of 2010, which he acknowledged would be very difficult in light of the G-20's diverse membership. Only after agreeing on a draft, which would need to be "soft enough" to get buy in from Brazil, China and India, and "not refer to the acquis of various international organizations like the OECD," should the

implementation phase begin. The plan is to consult with both the U.S. and major emerging economies by spring 2010, after which Germany will put forward its new paper. Nicolin expressed frustration at the high number of top-level meetings next year due to the transition from G-8 to G-20 format. He said that Russia, Japan and Italy wanted to keep the G-8 as a key forum. The G-8's development agenda still makes sense, but other elements should become more consultative. (COMMENT: This contradicts recent comments by Development Ministry (BMZ) officials, who would like development moved to the G-20.)

ECONOMICS MINISTRY: KNUT BRUENJES

¶8. (SBU) Ministry of Economics officials -- including Knut Bruenjes, Deputy Director General; Helen Winter, Head of Division, International and European Economic and Monetary Policy; and Matthias Koehler, Deputy Director, G8 Issues -- focused on exit strategies and worries over Greek bond spreads. Bruenjes thought that Germany's strong economic performance would boost other EU economies. He mentioned changes stemming from ratification of the Lisbon Reform Treaty, including introduction of majority voting on intellectual property rights (IPR) and investment issues, as well as the end of bilateral investment treaties among member states. He dismissed the notion of altering the German economy's export orientation, but acknowledged Germany was looking at ways to boost domestic consumption. One approach it will not pursue is allowing wage inflation to erode competitiveness. Winter stressed differences between the current account surpluses of Germany and China, whose surplus is linked to currency manipulation. Officials noted concerns over possible inflationary consequences of U.S. fiscal and monetary policy.

¶9. (SBU) Koehler fretted that the transition from G-8 to G-20

would spell a smaller role for Europe and Germany. The G-8 Heiligendamm Process, which includes China, India and Brazil, strikes an appropriate balance between involving important new economic players and the need to keep numbers to a workable level. The G-8 can continue to be important, especially on issues like climate and development, and as an informal preparatory core for G-20 discussions. Finance Ministers should continue to meet in G-7 format, where financial market regulation is an appropriate topic. Worried about trends towards a "G-2" with only the U.S. and China at the table, Bruenjes proposed that the U.S. and EU establish a common approach to China. He also said that Russia's customs union with Belarus and Kazakhstan would raise tariffs on some German goods and complicate its WTO accession, which the Russians want to complete in 2010.

COMMENT

¶10. (SBU) German government interlocutors were on the defensive when it came to Germany's current account surplus. There is a high degree of skepticism that Germany can or even should wean itself off exports or address its high savings rate. The government claims to be taking steps to increase domestic consumption via controversial tax cuts totaling 27.5 billion euros. (NOTE: The first installment of the two-year package, worth 8.5 billion euros, has cleared the Bundestag (lower house) and appears likely to pass the Bundesrat (upper house) within days. This initial package would adjust corporate tax rules, cut tax on hotel stays and increase child benefits.) It is unclear, however, what effect these measures will have on domestic consumption. Germany will have to begin reducing its budget deficit to comply with EU and constitutional limits by 2013, which could curtail consumption. It may therefore also be necessary to examine ways Germany can stoke domestic consumption outside the tax code.
MURPHY